

**EISNERAMPER**

# 2019 Private Equity Real Estate Market Outlook



In partnership with





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# REAL ESTATE: 2018 IN NUMBERS

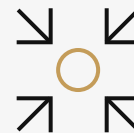
**D**espite uncertainty surrounding a potential market correction, private real estate experienced another strong year of fundraising in 2018; that being said, capital was more concentrated in the largest funds. The private real estate industry grew further, with total assets under management (AUM) surpassing \$900bn for the first time, while investors continued to see high capital distributions.

In 2018, **300 funds** raised an aggregate **\$124bn**.  
This marks the sixth consecutive year in which fundraising has surpassed \$100bn



Industry AUM surpassed \$900bn for the first time in 2018, reaching **\$909bn** as of the end of H1 2018

The 10 largest funds accounted for **35%** of total capital raised in 2018.  
**\$496mn** was the average size of funds closed in 2018



**\$212bn** was distributed to investors in 2017, slightly below the record \$270bn in 2016. **\$100bn** was distributed to investors in H1 2018

A record **6,418 PERE deals** were completed in 2018 for a record-high aggregate value of **\$325bn**



Across Preqin's November 2018 surveys, the largest proportions of investor and fund manager respondents see **asset valuations** and **rising interest rates** as key challenges for return generation in 2019

# THE CHANGING FACE OF PRIVATE EQUITY REAL ESTATE

Favourable market conditions and increasing institutional demand for real estate exposure have fuelled significant growth in the private equity real estate (PERE) industry in recent years. The fundraising market has been consistently strong, with more than \$100bn secured in each of the past six years. Driven by the growing demand for property and the large amount of capital at fund managers' disposal, the annual number and total value of PERE deals have reached record highs for the past five years. As the industry has matured, investors have received greater distributions and sought to re-invest capital in private real estate in search of the same public market outperformance.

As we enter 2019, however, market dynamics in the real estate industry may well be changing.

Valuations are widely considered to be high; many fund managers and investors surveyed by Preqin towards the end of 2018 believe we are at the peak of the cycle and expect a market correction at some point soon. Net cash flow to investors has slowed as fund managers call more capital in an effort to combat rising property prices. Although fundraising in 2018 was still strong, capital was more concentrated among larger managers as investors looked to established strategies in times of uncertainty. Lastly, 2018 observed the first year-on-year decrease in aggregate exit value on record, as managers looked to invest in property at a greater rate than they intended to sell.

While some longer-term trends prevail and continue to drive industry expansion, new growth areas are also identified as managers seek new ways to attract capital and find value for their investors.

## ESTABLISHED TRENDS

North America remains the hub of the private real estate industry, as the destination for the majority (63%) of capital raised in 2018 and, unsurprisingly, the majority (64%) of total PERE deal value also.

Many top-tier cities in the US, and indeed in developed Europe, recorded an increase in PERE deal value over 2018: New York, London, Chicago,



**LISA KNEE**

National Leader, Real Estate Private Equity Group

Frankfurt and Washington all recorded an increase in annual deal value. Faced with potential property price volatility, assets in top-tier cities can provide protection as they are more cyclically resilient than those in emerging cities/markets.

## GROWTH AREAS

Office assets represented the greatest share (36%) of PERE deal value of all property types in 2018. Residential property follows at 22% of total deal value – the segment's largest share of the market in recent years. This uptake is largely driven by increased investment in multi-family property, a growing area for investment: total deal value for multi-family assets was \$72bn in 2018, up 26% in comparison to 2017 (\$57bn).

With the unrelenting rise of e-commerce continuing to impact private real estate investment, the industrial sector has experienced substantial growth in a short amount of time: total deal value for industrial property in 2018 was 3x that of 2012. Furthermore, more deals were completed for industrial than retail property for the first time on record in 2018. As consumer habits evolve, we expect this area of the market to only continue to build momentum through 2019.

Private real estate debt tells another story of standout growth in recent years. A record \$33bn was secured for debt investment in 2017, followed by a robust \$26bn in 2018. Investors continue to seek exposure to the lower risk/return profile afforded





by debt investments, looking to protect their real estate holdings in the event of price decreases given the greater security at the top of the capital structure.

Investors and fund managers are also evaluating how best to access the market in the coming year. One-fifth of investors surveyed by Preqin plan to invest in real estate via co-investments in 2019, as the market for custom vehicles looks set for growth.

Recent regulation has also provided opportunity for private real estate fund managers in the US, with the Opportunity Zone Program providing significant tax and economic benefits for investors, real estate developers and fund sponsors. As such, fund managers have sought to offer Qualified Opportunity Funds (QOFs), strategies able to benefit from this program if they match the QOF requirements, delivering advantages to investors through real estate investment as well as tax relief.

### **PRIVATE REAL ESTATE IN 2019**

Investors remain committed to real estate in the face of great uncertainty in the market. Although one-third of surveyed investors expect worse performance from their real estate holdings in 2019, the majority (53%) anticipate similar returns. Investors are also planning fresh investment in 2019, with 58% looking to invest the same amount of capital in 2019 as they did in 2018, and a further 23% planning to increase their capital investment.

Investors appear largely confident in the asset class, and the private fund model has previously proven its ability to provide capital protection in times of market volatility and deliver public market outperformance. Funds of vintages 2007-2008, for example, which began investing in the period surrounding the Global Financial Crisis, are now showing positive median net IRRs. With many market participants placing us at the peak of the cycle with a potential market correction on the horizon, investors will be looking to private investment in 2019, and indeed beyond.

# FUNDRAISING IN 2018

Fundraising for private real estate managers was certainly challenging in 2018, as high valuations and concerns over a potential market correction took their toll. The data shows, though, that investors continued to deploy capital in spite of the prevailing uncertainty, and fund managers collectively raised more than \$100bn for the sixth consecutive year (Fig. 1). Looking ahead, Preqin's latest survey suggests that investors remain undeterred: four in five are planning to maintain or increase their level of investment in real estate in 2019 compared to 2018. The increasing capital concentration among larger managers, though, will make for a competitive fundraising environment, which may leave many funds struggling to source allocations.

## NORTH AMERICA: THE PROPERTY HUB

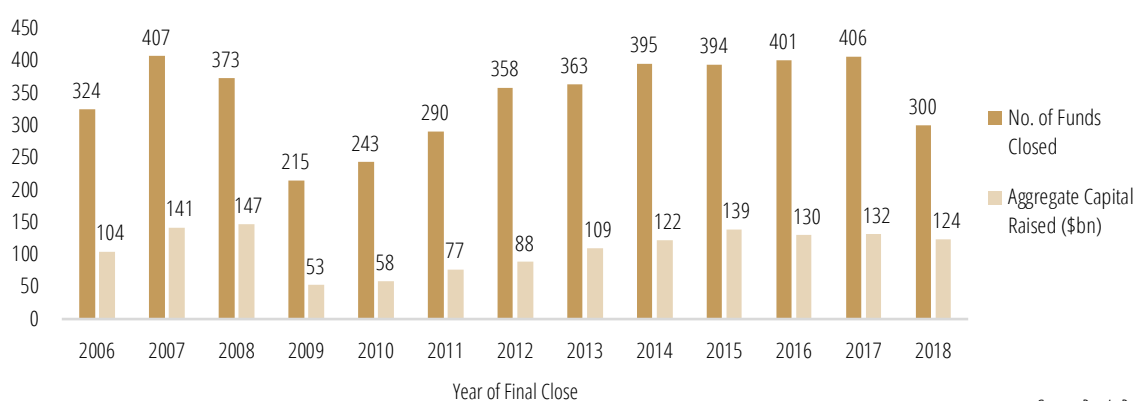
As in previous years, North America was the dominant geographic focus for private real estate

in terms of both number of funds raised (203, representing 68% of the global total) and aggregate capital secured (\$78bn, 63%) in 2018. Elsewhere, property markets in Asia continue to attract capital: capital focused on Asia represented the greatest proportional increase from 2017, accounting for 8% of total capital raised in 2017 and 12% in 2018.

## INVESTORS TARGET DEBT

Notably, private real estate debt funds have continued their ascension of recent years (page 16). Many investors sought exposure to the lower risk/return strategy over 2018, with \$26bn in total capital raised marking the fifth time in the past six years that capital secured for debt strategies has surpassed \$20bn, despite not matching the record \$33bn secured in 2017. Higher-risk strategies continue to attract the majority of capital: value-added and opportunistic strategies raised 69% of capital secured in 2018 (Fig. 2).

Fig. 1: Annual Global Private Real Estate Fundraising, 2006 - 2018



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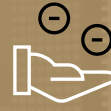
*Demand for real estate continued in 2018 as the US economy grew steadily and the low interest rate environment has capital looking for alternative means of generating returns. Real estate once again proved to be top on this list given its attributes as a tangible asset with consistent cash flow potential.*

*David Lorber, Co-Founder, FrontFour Real Ventures*





The 10 largest funds closed in 2018 secured 35% of all capital raised, up from 23% in 2017.



\$7 of every \$10 committed to private real estate funds in 2018 went to value-added or opportunistic strategies.

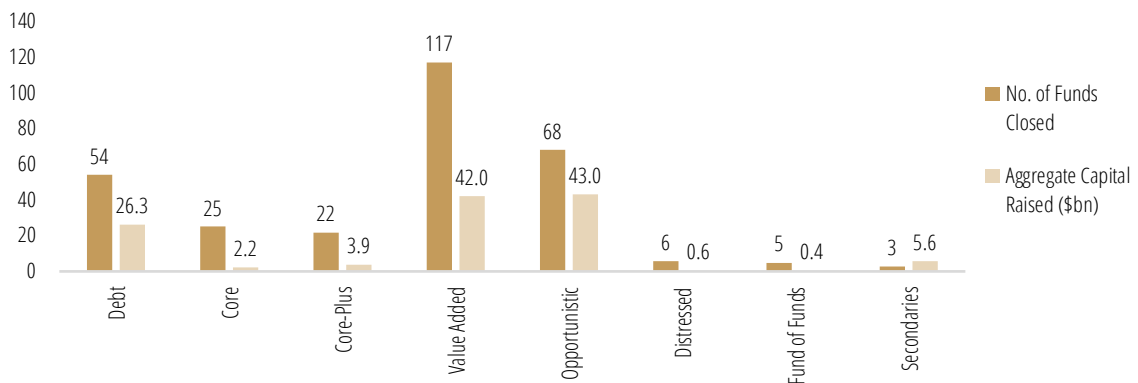
### A TRAFFIC JAM?

As demand for real estate increases, more and more vehicles are entering the private real estate market each year (Fig. 3). That being said, the amount of capital targeted by funds on the road as of January 2019 has increased at a greater rate over the past 12 months (+28%) than the number of vehicles (+16%), buoyed by Blackstone Real Estate Partners IX which is seeking to raise \$20bn. In this crowded marketplace, competition is rife: nearly twice as much capital is currently being sought by funds in market than the amount secured by funds closed in 2018. The demand for real estate debt is again highlighted, with just 1.4x the amount of debt capital secured in 2018 currently being sought.

### RAISING CAPITAL IN 2019

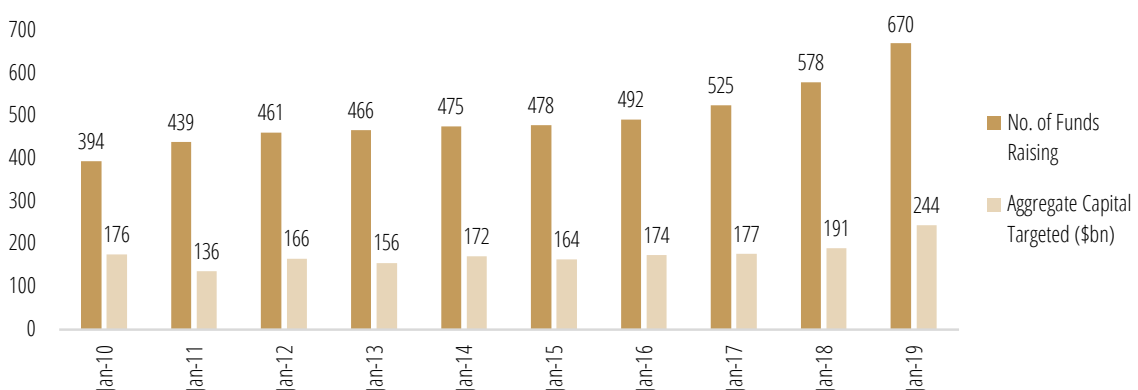
Capital concentration and market uncertainty cultivated a challenging fundraising environment for most private real estate managers in 2018. While higher-return strategies continue to attract the majority of capital targeting equity investment, investors are considering debt strategies to diversify against potential real estate valuation decreases. As seen on page 21, many participants feel property is overpriced and expect a market correction, but are uncertain of the timing. Whether the correction occurs imminently or not, the challenge for 2019 is undoubtedly how to successfully navigate a changing market.

Fig. 2: Global Private Real Estate Fundraising in 2018 by Primary Strategy



Source: Preqin Pro

Fig. 3: Private Real Estate Funds in Market over Time, 2010 - 2019



Source: Preqin Pro

# ASSETS UNDER MANAGEMENT

A number of factors have driven up total private real estate industry assets in recent years: annual fundraising remains strong, high valuations have boosted fund performance and investors continue to enter and re-invest in the market. These long-term trends continued in 2018, and with a record-high number of funds on the road (page 7) and many investors planning increased investment in the coming year, the industry looks poised for further expansion in 2019.

## INDUSTRY ASSETS SET NEW RECORD

In an era of consistent growth, real estate industry AUM stands at \$909bn as of the end of Q2 2018 (the latest data available) – this marks a 12% increase from December 2017 and is a record high (Fig. 4). Fund managers collectively have more capital ready to deploy in the market than ever before, with industry dry powder having grown to \$323bn. In both 2016 and 2017, the level of unrealized value in the market dropped as almost \$0.5tn was distributed to investors over the period. However, as of June 2018, the value of unrealized property held in private funds is up 10% on December 2017, sitting at a record \$586bn, linked in part to the decrease in PERE exit activity (page 15).

## DEBT AND CORE STRATEGIES LEAD GROWTH

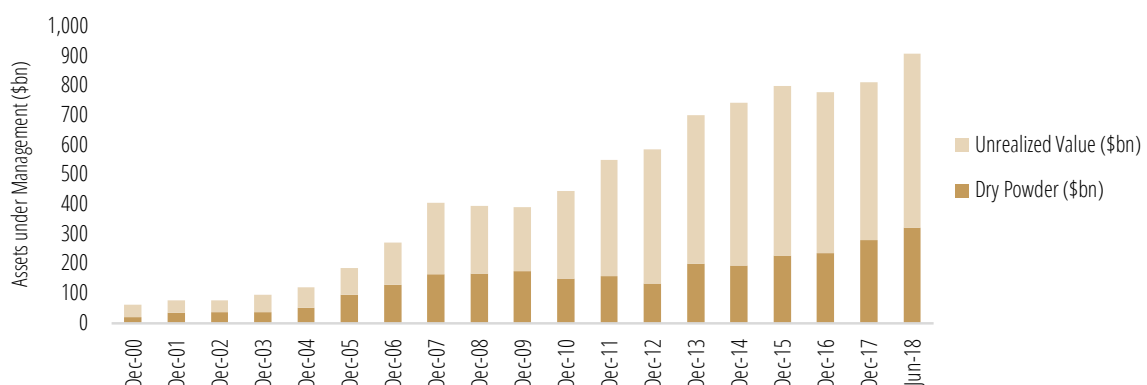
While aggregate assets for each top-level strategy have grown significantly over the past decade, debt and core strategies are the only segments to have recorded material growth in assets over the past two years.

At around 35% of total AUM, the level of dry powder as a proportion of industry assets is relatively uniform across individual real estate strategies (Fig. 5). Core strategies sit at the lower end of the scale, and 73% of assets are held within portfolios. In comparison, the relatively recent growth of the real estate debt strategy means that 41% of total assets in such vehicles are still held as dry powder.

## DISTRIBUTIONS TO LPs SLOW

From 2009 to 2016, the level of capital distributed back to investors increased year on year, with net cash flow turning positive in 2013 – meaning that LPs received more capital back from funds than was called up (Fig. 6). Net cash flow remained positive in 2017, despite the amount of capital distributed to investors falling from the previous year for the first time since 2009. The \$80bn of capital called up in

Fig. 4: Private Real Estate Assets under Management, 2000 - 2018



Source: Preqin Pro





Private real estate assets have doubled over the past decade and stand at a record \$909bn (as of June 2018).

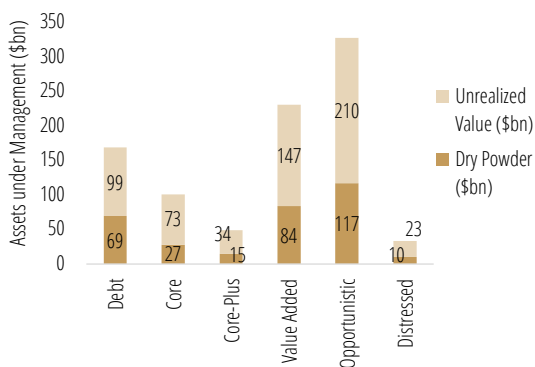
H1 2018 puts 2018 on course to record one of the highest ever annual totals of capital called, perhaps linked to rising asset valuations and the extra capital required to execute transactions when the market is at its peak.

### FORECAST OF GROWTH IN 2019

Among fund managers surveyed by Preqin at the end of 2018, many foresee challenges ahead in the form of high asset valuations and intense market

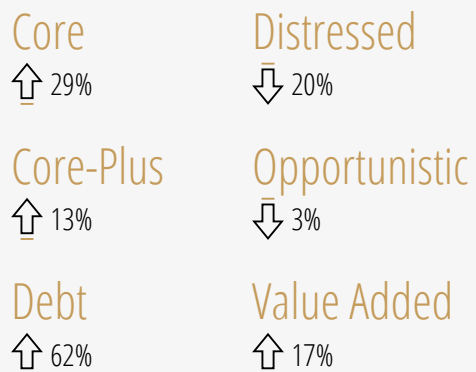
competition; despite this, 85% of respondents predict that industry assets will grow further over the course of 2019. With many market participants planning to deploy more capital in 2019 compared to 2018, it seems that, at least in the shorter term, the private real estate industry is on track to reach \$1.2tn in total assets by 2023, as predicted by Preqin in August 2018.<sup>1</sup>

**Fig. 5: Private Real Estate Assets under Management by Strategy**

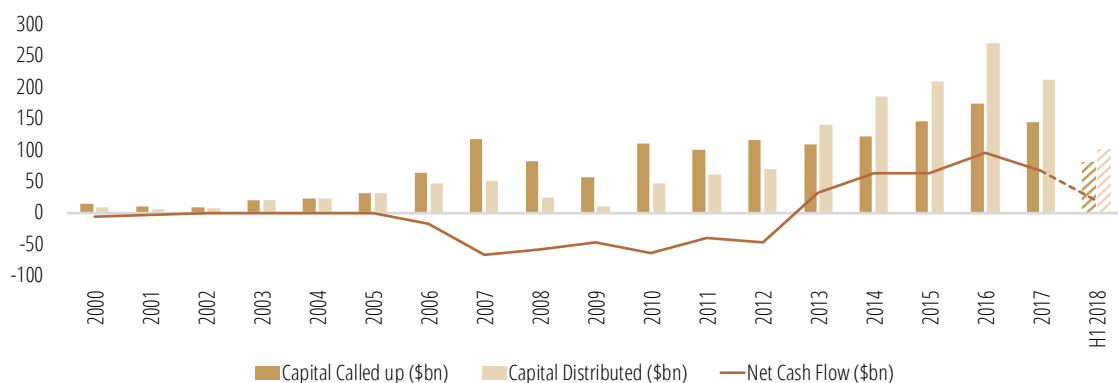


Source: Preqin Pro. Data as of June 2018

Growth in aggregate strategy AUM since December 2015 (as of June 2018):



**Fig. 6: Private Real Estate: Annual Capital Called up, Distributed and Net Cash Flow, 2000 - H1 2018**



Source: Preqin Pro. Data as of June 2018

<sup>1</sup> 'The Future of Alternatives,' Preqin: [www.preqin.com/future](http://www.preqin.com/future)

# QUALIFIED OPPORTUNITY FUNDS

In the US, the Tax Cuts and Jobs Act (TCJA) of 2017 provided significant tax and economic benefits for investors, real estate developers and fund sponsors through the Opportunity Zone Program. Qualified Opportunity Zones (QOZs) were designed to spur long-term growth and economic development in economically distressed neighbourhoods through tax incentives. Since enactment, Qualified Opportunity Funds (QOFs), the instrument to invest in these zones, have become a very hot topic.

A fund must elect to be treated as a QOF at any time after 31 December 2017, and must be formed as a corporation or partnership for the purpose of investing in QOZ property or businesses.

## QOF REQUIREMENTS

One of the main requirements for a QOF is that at least 90% of its assets must be QOZ Property. QOFs will need to consider the business plan (i.e. into what assets to deploy capital) as well as how to properly apply the testing requirements.

QOZ Business Property is defined as:

- Tangible property used in a trade or business acquired by purchase after 2017 from an unrelated party.
- Acquired in a QOZ.
- Qualifying either through original use or "substantial improvement."
- During substantially all of the QOF's holding period for such property, substantially all of the use of such property is in a QOZ.

QOZ Stock and QOZ Partnership Interests are:

- Investments in, or ownership of, corporate stock or partnership interests in a QOZ Business acquired after 2017 from the corporation/partnership solely in exchange for cash.

## INVESTOR BENEFITS

Any capital gain from the sale or exchange of property by a taxpayer to an 'unrelated' party that is invested in a QOF within 180 days of the sale of such property is excluded from gross income until the earlier of the date the investment in the QOF is sold or 31 December 2026.

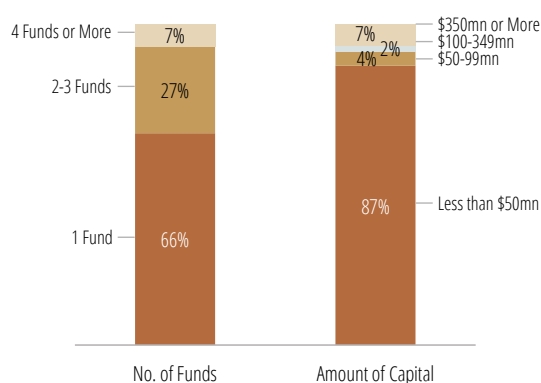
An investor's basis in the QOF is initially zero but will be increased by: (a) 10% of the deferred gain if the investment is held for five years by 31 December 2026; (b) an additional 5% of the deferred gain if the investment is held for seven years by 31 December 2026; and (c) any deferred gain recognized at the end of the deferral period (31 December 2026).

Therefore, if a gain on the sale of property is reinvested in a QOF within the required timeframe, investors may be able to decrease the taxable portion of the originally deferred gain by 15% (an overall basis step-up of 15%) if the investment is held seven years or more by 31 December 2026.

## INVESTORS TARGETING QOFs

There is a lot of interest surrounding the newly introduced QOF market. In January 2019, Preqin conducted a survey of investors to gauge their perception of these new investment vehicles, and understand how QOFs may impact their investment plans going forwards. Due to the uncertainty surrounding unfinished regulations, as well as the risks associated with investing in distressed regions, the survey found that LPs are wary of investing in opportunity zones, with 92% of surveyed investors not currently invested in QOFs. However, 51% of respondents are considering investing in QOFs in the next 12 months, and a further 12% would be interested in investing after this timeframe, highlighting the interest in this nascent industry.

**Fig. 7: Investors' Plans for Investment in Qualified Opportunity Funds in the Next 12 Months**



Source: Preqin Investor Interviews, January 2019

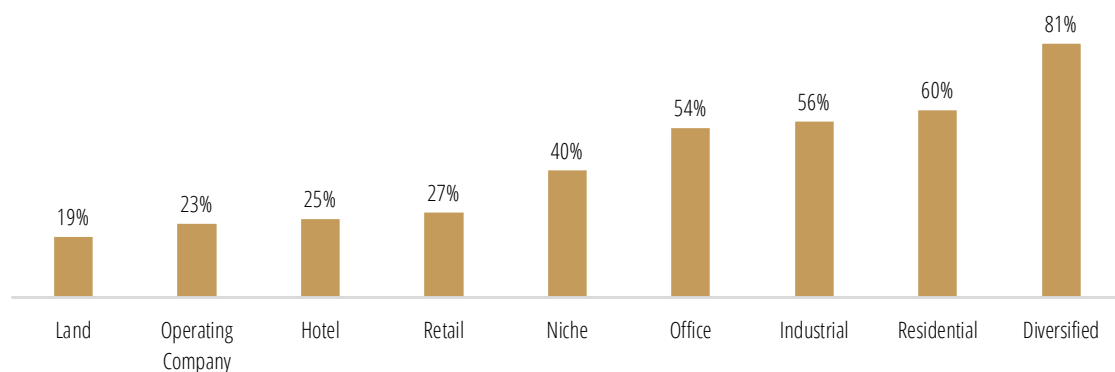


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*In addition to offering tax benefits, the Opportunity Zone Program is serving to shine a light on the compelling returns available from investments into low- and moderate-income communities in secondary MSAs.*

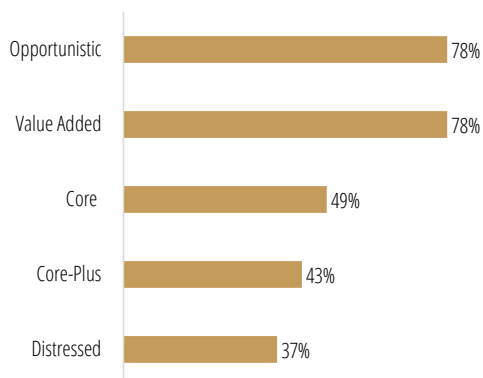
*Tony Barkan, CEO/Co-Managing Principal, Allagash Opportunity Zone Partners LLC*

**Fig. 8: Property Types Targeted by Investors for Qualified Opportunity Fund Investments**



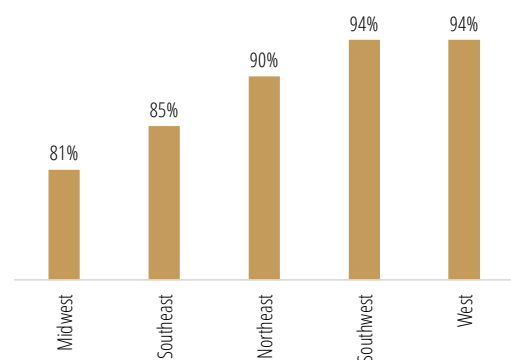
Source: Preqin Investor Interviews, January 2019

**Fig. 9: Real Estate Strategies Targeted by Investors Considering Qualified Opportunity Funds**



Source: Preqin Investor Interviews, January 2019

**Fig. 10: Regions Targeted for Investors' Qualified Opportunity Fund Investments**



Source: Preqin Investor Interviews, January 2019

# REITs

## THE BENEFITS OF REITs IN PRIVATE FUNDS

The use of real estate investment trusts (REITs) in PERE fund structures has long been advised as a prudent strategy. Specifically, tax-exempt and foreign investors have historically been the key driver behind fund managers implementing this structure because of the tax benefits that have been afforded to those investors. US-based investors, however, were historically neutral, or even negatively biased, against the REIT entity due to the loss of pass-through losses and taxation at the highest tax rates.

Because of new benefits from the TCJA, fund managers need to understand and consider REITs more than ever before as they structure their funds and look to attract investors. US investors now have new tax incentives through a REIT structure. Fund managers also have administrative and cost incentives for utilizing REITs.

## TAX BENEFITS OF REITs

Under the TCJA, the use of REITs has the ability to provide significant tax benefits not only for tax-exempt and foreign investors, but also for US-based investors.

### REITs as a Blocker of Unrelated Business Taxable Income (UBTI) and Effectively Connected Income (ECI) with a US Trade or Business

Tax-exempt investors are subject to tax on UBTI. Real estate rental income is generally excluded from UBTI; however, there is a major exception when real estate is financed with debt. Debt-financed income is generally subject to UBTI tax (an exception exists for certain qualified organizations). A REIT transforms rental income into dividends which are not treated as UBTI.

### Section 199A Qualified Business Income 20% Deduction

One such benefit is Section 199A under the TCJA, which allows taxpayers a 20% deduction against certain types of qualified business income but is subject to wage and/or basis limitations. REIT dividends are also eligible for the 20% deduction but are not subject to the wage and/or basis limitations.

## State Filings

A REIT files state tax returns for the states where the real estate is held. The dividends that are reported to US-based investors are generally only taxable in an investor's resident state, so this eliminates the need for multiple state tax filings at the investor level as well as the onerous tax-withholding requirements.

## Compliance Timing and Costs

A REIT only reports dividends to its shareholders (i.e. the fund partnership), and the determination of whether there are taxable dividends is made at the beginning of the year; therefore, the fund partnership return, along with investor K-1s, can be prepared and distributed in a timely manner.

As the only activity flowing to investors consists of dividend income and tax withholding is not required on behalf of the investors, the investors themselves may recognize compliance cost savings as a result of filing in less states.

*At Emerald Creek, our number-one goal is to do what is right for our clients. By creating a REIT, we were able to lower our investors' tax rate by 20%.*

“

*Mark Penna, Managing Partner & Co-Founder, Emerald Creek Capital*

*Our existing taxable investors were pleased to learn that their same investments would now be tax-advantaged through the REIT structure. It was an obvious choice for us.*

“

*Russell Diamond, Founding Partner, Alcova Capital*

Source: The Benefits of REITs in the Real Estate Private Equity Fund Structure. By Michael Torhan, CPA



# ATTRACTING CAPITAL

**T**argeted for its diversification benefits and potential as a reliable income stream, real estate holds an important place in many investor portfolios. Despite the concerns in the industry surrounding high valuations and competition, over \$100bn was committed to private real estate funds in 2018, and 80% of investors surveyed by Preqin in November in 2018 plan to maintain or increase their investment in the asset class in 2019 compared with 2018.

## COMPETITION ON THE RISE

As the demand for real estate grows, so does the number of participants in the market: nearly three-quarters (71%) of fund managers surveyed by Preqin reported that competition for investor capital had increased over 2018. In these conditions fund managers must stand out in a crowded market to secure their targeted commitments.

## GREATER APPETITE FROM FAMILY OFFICES

Fund managers must also evaluate their sources of capital as changing economic dynamics create new opportunities. Pension funds have long been an important source of capital for real estate GPs and this investor group continued to seek opportunities in 2018, representing 30% of all mandates (Fig. 11).

Family offices represented 15% of all mandates issued in 2018; however, fund managers are reporting greater appetite for real estate investment among family offices. Linked in part to the rise in generational wealth in developing nations, Preqin's 'Future of Alternatives' study, conducted in August 2018, showed that 65% of surveyed fund managers expect family offices to be a more important investor type in private markets by 2023.

## INVESTMENT IN 2019

As we look to investors' planned investment, the majority will be targeting developed markets in 2019. Two-thirds (63%) of surveyed investors will be looking to allocate solely to opportunities in developed markets, with a further 31% targeting investments across a mix of developed and emerging markets. Investors perhaps have one eye on a potential market correction, with property in developed markets, or more specifically top-tier cities, more likely to be cyclically resilient than property in emerging markets.

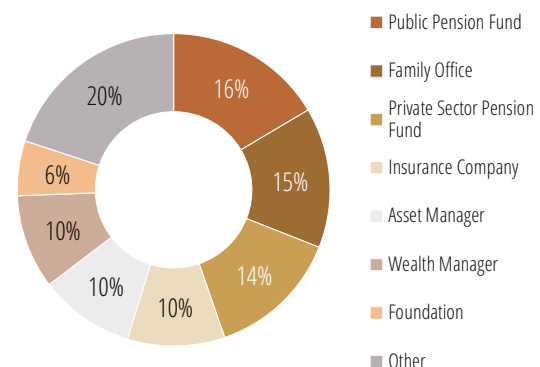
In the current market, however, attracting capital goes beyond employing the right strategy. In such a competitive environment, a lack of LP-friendly factors such as ESG reporting and co-investment opportunities (page 17) are potential deal-breakers.

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*The investors that invest with us are looking for near-term value creation in our assets and long-term appreciation while also providing downside protection when a correction arrives. Attracting investment is about alignment with your investors on a specific strategy or strategies.*

*Patrick Fisher, Managing Partner, Lift Partners*

**Fig. 11: Real Estate Mandates Issued in 2018 by Investor Type**



Source: Preqin Pro

# DEALS IN 2018

Fund managers deployed record amounts of capital in the real estate market in 2018, with PERE deal activity matching the record levels seen in 2017 (Fig. 12). Amid prevailing uncertainty in the market, many fund managers altered their strategy in response to increasingly high valuations and a maturing cycle. Although some longer-term trends prevail, there are changing dynamics at play. GPs are looking to growth sectors in a bid to diversify and find value, and with core market valuations remaining high, these sectors are likely to see further activity in 2019.

## NORTH AMERICA DRIVES ACTIVITY

Up by 14% to \$209bn, North America was the only top-level region to record an increase in the value of completed PERE transactions in comparison to 2017 (Fig. 14). The amount of capital deployed in Europe stayed relatively level in 2018 despite fewer deals being completed. Aggregate deal value fell in both Asia and Rest of World in 2018, with each region recording approximately half the total for 2017.

## RESIDENTIAL AND OFFICE MARKETS

The traditionally dominant office and residential assets, sought after for their stability and likelihood of steady rent, accounted for 58% of total PERE deal value in 2018 (36% and 22% respectively).

In 2018, residential property recorded its largest share (22%) of total PERE deal value in recent years. This proportional increase was driven by growth in the total value of multi-family transactions – a market seeing increased activity in the private real estate space – with residential deal value increasing from

\$60bn in 2017 to \$72bn in 2018 (Fig. 13), including the largest PERE transaction of the year, the \$1.9bn portfolio deal between Brookfield Property Group and Carmel Partners.

## THE E-COMMERCE IMPACT

The retail industry has been under the microscope in recent years as e-commerce activity continues to impact consumer habits. PERE retail deals made up 13% of both the number and aggregate value of PERE deals completed in 2018, down from 18% and 16% respectively in 2012.

While e-commerce has created challenges in the retail space, it has undoubtedly created opportunity in the industrial market. Not only were more PERE transactions completed for industrial property than retail in 2018 – the first time on record – but the aggregate value of industrial deals in 2018 was 3x the amount recorded in 2012. Warehouses and distribution centres have become central to the success of e-commerce, and fund managers have sought exposure to the opportunity this presents.

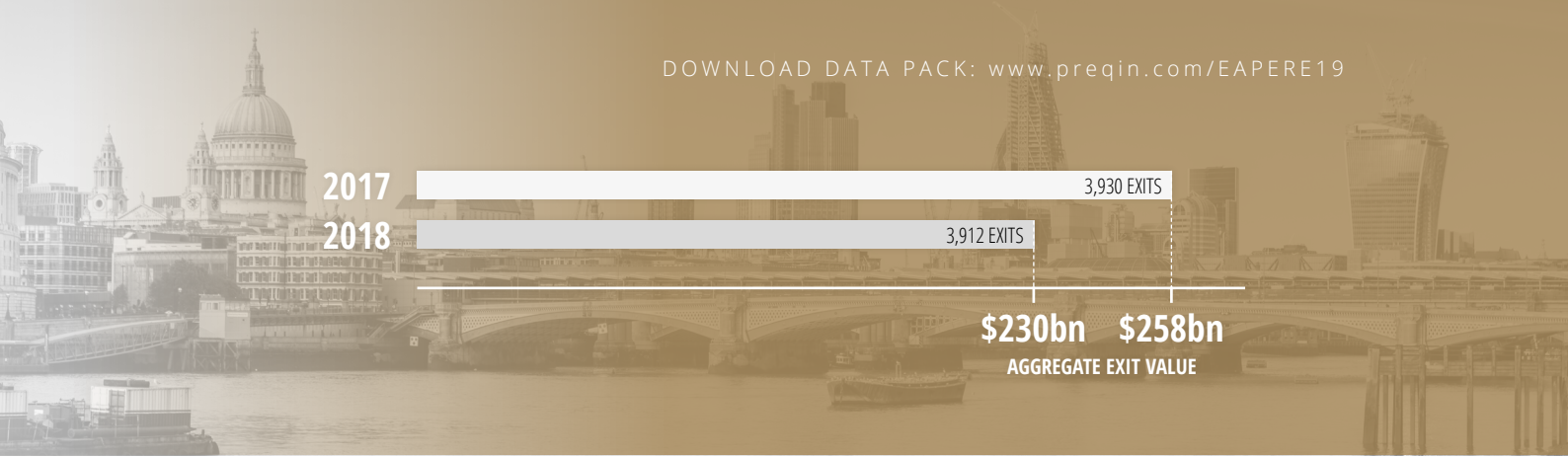
## UNCERTAINTY IN THE CYCLE

As valuations increase and market competition intensifies, many industry participants expect a correction in property prices. Most investors (64%) and fund managers (71%) surveyed by Preqin at the end of 2018 believe the market cycle is currently at its peak, and a further 40% of fund managers expect a market correction in 2019 (page 21). If property valuations do begin to fall, PERE deal activity may continue at record levels as fund managers look to deploy capital against a new market dynamic.

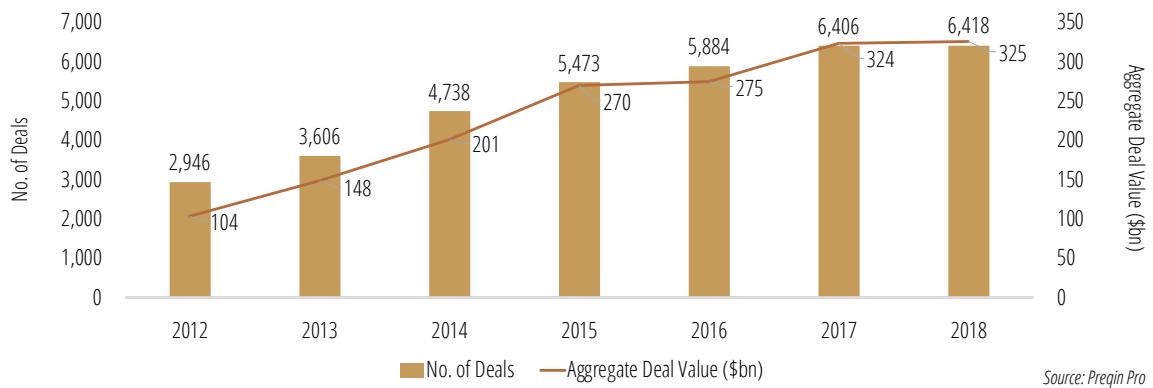
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*Currently there is a heightened focus on asset value durability and the potential for reduced margins going forward. These factors have increased the interest level in investing in niche market sectors with fully integrated platforms that can control costs and have better execution. Investing with a fully integrated platform focused on rent-stabilized workforce housing in major coastal markets is an investment strategy that fits this criteria and is able to offer investors attractive risk-adjusted returns at this point in the cycle.*

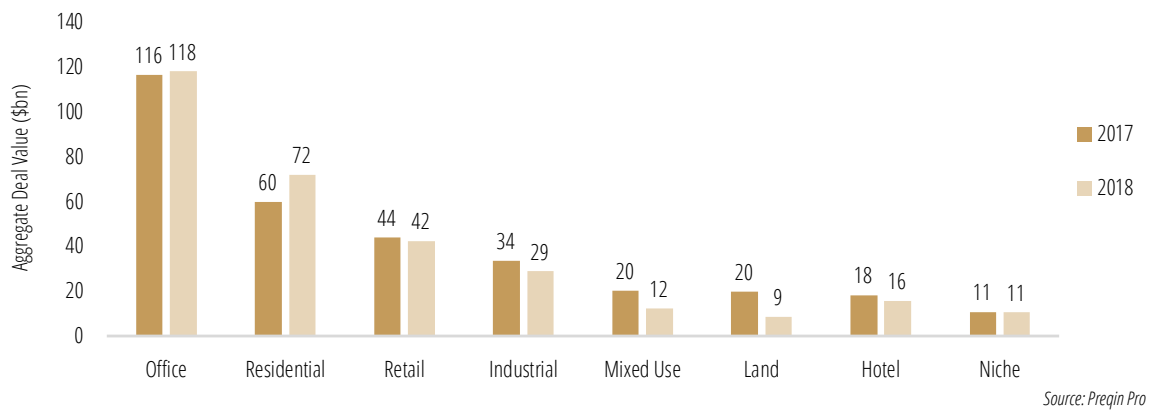
*Jim Farris, Co-Founder & CEO, Mosser Capital*



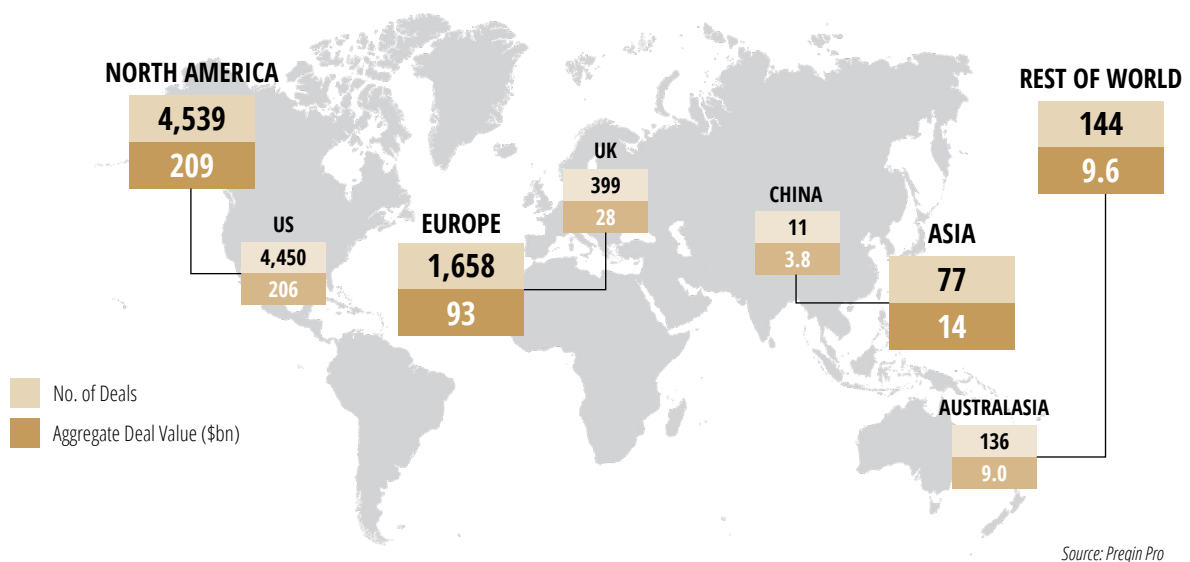
**Fig. 12: Global PERE Deals, 2012 - 2018**



**Fig. 13: Aggregate Value of PERE Deals by Property Type, 2017 vs. 2018**



**Fig. 14: PERE Deals in 2018 by Location**





# IN FOCUS: PRIVATE REAL ESTATE DEBT

The private real estate debt market has grown significantly in recent years as fund managers have sought to capitalize on the opportunity provided by banking regulation, and investors have targeted exposure to the stable income and portfolio diversification debt investments can provide. However, it is not only the risk/return profile that attracted investors to debt strategies: investors likely have one eye out for a potential change in the cycle, and the downside risk protection that debt investments offer at the top of the capital structure makes them more secure than low-yield equity investments in the event of a price shift.

## ASSETS GROWING FAST

Debt has been one of the fastest-growing investment segments within private real estate in recent years: debt assets represented just 7% of the private real estate industry in December 2008, and this has increased to 19% as of June 2018 (the latest available data).

The level of capital available to fund managers for debt investments reflects the relative youth of the strategy. Across the private real estate market, dry powder sits at around 35% of total assets; for debt vehicles, however, this figure rises to 41%, with many debt funds yet to complete their investment periods.

## FUNDRAISING REACHES RECORD

Once a niche segment, debt funds have secured \$20bn or more in fundraising in five of the past six years (Fig. 15). 2017 holds the record for both the number of private real estate debt funds reaching a final close (67) and aggregate capital secured (\$33bn), driven by consistently large debt funds reaching a final close: 15 funds secured \$1bn or more in 2017, significantly more than the four \$1bn+ funds closed in 2016 and six in 2018. Fundraising activity in 2018 was buoyed by Broad Street Real Estate Credit Partners III closing in January on \$6.4bn; The Goldman Sachs Group's fund is the largest private real estate debt fund ever raised.

## Private Real Estate Debt Assets under Management (\$bn), 2008 - 2018

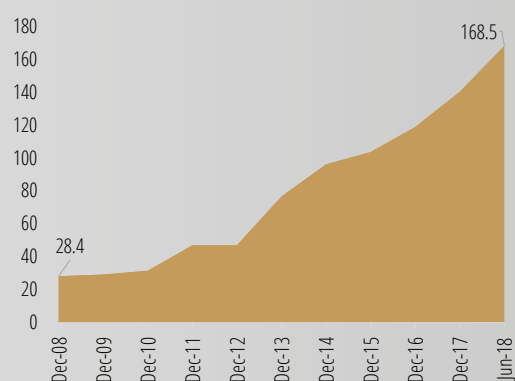
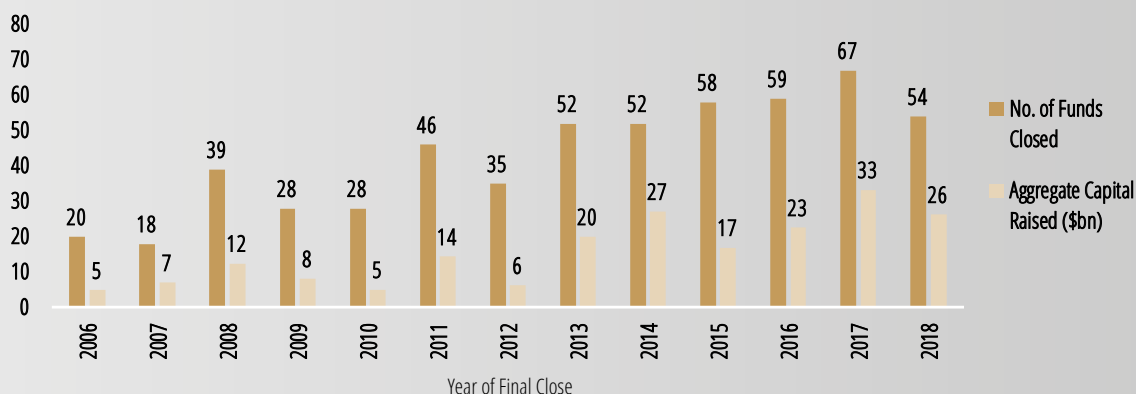


Fig. 15: Annual Global Private Real Estate Debt Fundraising, 2006 - 2018



Source: Preqin Pro

# IN FOCUS: ALTERNATIVE STRUCTURES

As LPs target more customized solutions to complement their fund holdings, the private real estate industry has witnessed growing demand from investors for alternative structures in the form of co-investments and separate accounts over recent years. While co-investments and separate accounts require greater capital and resources than maintaining a real estate portfolio allocated solely to pooled vehicles, these structures can offer greater exposure to attractive assets, more control over investment timing and potentially lower fees.

As seen in Fig. 16, large investors – mainly sovereign wealth funds, funds of funds and family offices – are typically the most active in these alternative routes to market, given the capital requirements of these vehicles. Although pension funds are some of the most active investors in private real estate, the universe of pension funds accessing real estate by these structures is relatively small, with under

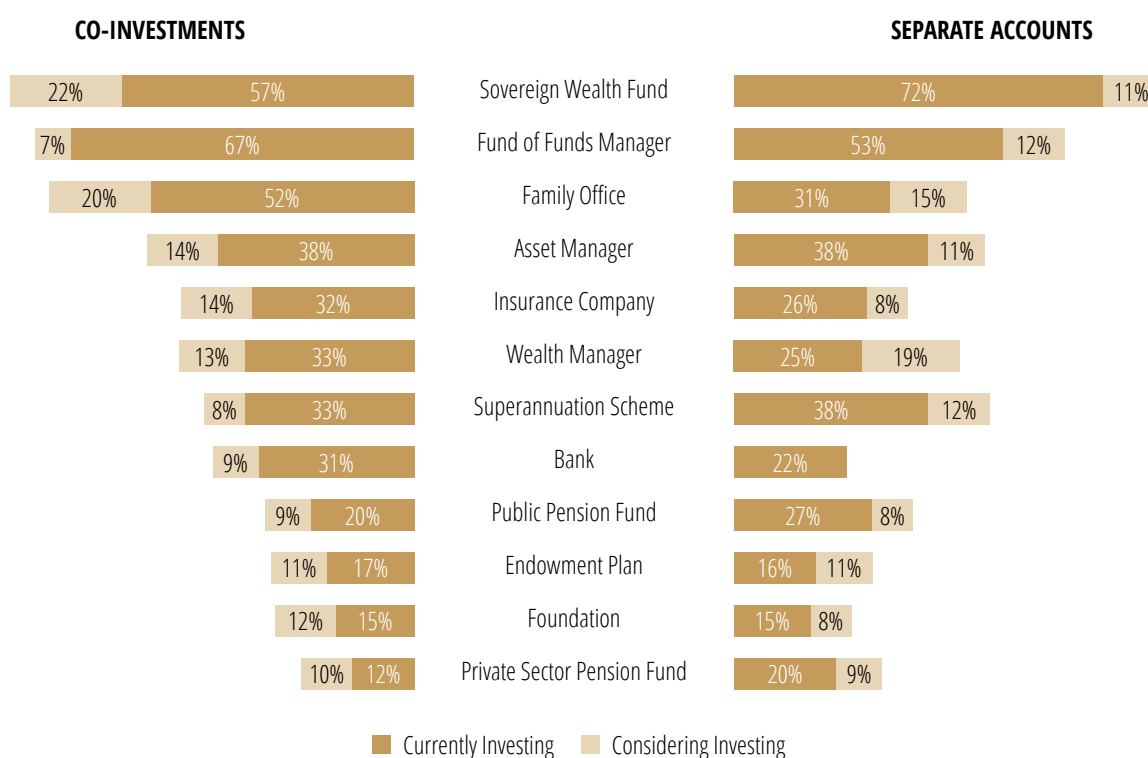
one-third utilizing co-investments in their real estate portfolios.

## ALTERNATIVE ROUTES TO SOPHISTICATION

Pooled funds remain the most targeted structure for future investment in real estate. Yet, as investors have become more sophisticated, so too have their portfolios, as they seek custom solutions to complement their fund holdings. Twenty-one percent of private real estate investors surveyed by Preqin will target access to co-investments in the coming year.

As the demand for custom vehicles grows, many fund managers are seeking to expand their offerings. Nearly half of all managers surveyed by Preqin plan to offer more co-investment (46%) and separate account (45%) solutions in 2019 than they did in 2018, in a bid to attract investor capital and build relationships in a fiercely competitive market.

Fig. 16: Investor Appetite for Real Estate Co-Investments and Separate Accounts by Type



Source: Preqin Pro

# FUND TERMS & FEES

## FUND TERMS AND CONDITIONS

Fund terms and conditions are an important aspect of fund agreements between GPs and LPs. It is essential that the interests between the two parties in this area are closely aligned to ensure a harmonious working relationship during the lifetime of a fund, and potentially thereafter in the form of re-ups or positive sentiment within the investor community.

Investors understand that fund managers must be appropriately remunerated and incentivized for delivering strong performance, but also expect to secure guarantee clauses that protect their capital.

## MANAGEMENT FEES

Fig. 17 shows the breakdown of fund terms and conditions charged by closed-end private real estate funds in market and funds closed of vintage 2017/2018. Much like the rest of the private capital industry, the largest real estate funds (funds raising and vintage 2017/2018) of more than \$500mn in size charge lower management fees compared to their smaller counterparts, which is unsurprising given

the economies of scale larger GPs can utilize (size categories less than \$500mn).

## CONTRACTUAL CLAUSES

A key-man clause is increasingly commonplace within a fund's terms and conditions. The majority of private real estate funds in market and funds closed of vintage 2017/2018 operate with a key-man clause, as investors look to ensure key personnel remain with the fund throughout its lifetime.

LPs also look to maintain control of their invested capital through terms such as a no-fault divorce clause, where LPs can replace the managing GP if an agreed proportion, typically a supermajority, of investors vote to do so.

With competition for investor capital in the private real estate market increasing (page 13), fund terms and contractual clauses are more important than ever for investors looking to allocate capital to private funds.

**Fig. 17: Fund Terms Overview: Private Real Estate Funds Raising & Vintage 2017/2018 Funds Closed**

Key Terms		Benchmark Average	Variations/Comments
Management Fee	Investment Period	Funds below \$100mn: 1.5%	Mode 2%
		Funds \$100-249mn: 1.5%	
		Funds \$250-499mn: 1.5%	
		Funds \$500-999mn: 1.3%	
		Funds \$1bn or above: 1.4%	
	Post-Investment Period	Same rate; charged on invested capital	Notable proportion of funds made no changes during post-investment period
Carried Interest	Basis for Distribution	Whole fund	
	Percentage	20%	
	Hurdle Rate	8%	
GP Commitment		2%	Wide range; large proportion of GPs making contributions of more than 10%
Minimum LP Commitment		1.5%	
No-Fault Divorce Clause		Yes; 75% LP majority needed	37% of funds without no-fault divorce clause
Key-Man Clause		Yes; 1 level	
Investment Period		3 years	

Source: The 2018 Preqin Private Capital Fund Terms Advisor



# INVESTING IN 2019

*We recently sat down with Maurice Malfatti, Managing Partner at Blue Heron Asset Management, to discuss the outlook for the real estate industry and where the opportunities may lie.*

## **What has driven the growth of the private real estate market in recent years?**

In short, strong real estate performance and appetite for greater exposure to yield-producing assets. Further, the ongoing 'institutionalization' of real estate as an asset class provides for improved liquidity and transparency; investors view real estate as an asset class with strong yield potential, with intrinsic value and, particularly in short-duration lease properties like multi-family, as a hedge against inflation.

## **Where are you seeing the best opportunities to invest in the current market?**

We believe that investing in high-growth '18-hour' secondary markets in the Southeast, particularly those that exhibit sustainable, strong job and population growth relative to the nation, offers compelling risk-adjusted returns. In addition, we believe that investing in assets that require hands-on operational expertise and strong asset management to create and preserve value is key in the current market.

## **Are there any new segments of the market that you are expecting to see growth in over 2019/2020?**

The growth of real estate-related technology and data analytics, and their implementation, will continue to grow. In today's market, technology is being employed across the spectrum of real estate investment, from faster, more detailed investor reporting to technologies at the property level that handle e-commerce packages, 'shared economy' amenities and tenant experiences. Just as Blue Heron is beginning to evaluate best-in-class solutions to manage our data and refine our analytics through technology, we believe that we will see many more real estate players and projects implementing new technologies.

As a demographic trend, we have seen a significant increase in 60+ year-old renters, particularly in our markets/the Southeast. The move away from home ownership to renters and a focus on experience over ownership is permeating all age groups, not just millennials.

## **What do you see as the challenges to successfully investing in real estate in 2019/2020?**

Strong competition for good real estate assets presents a challenge for investors looking to deploy capital as cap rates have been driven lower and prices higher. But, this creates an opportunity for those who are well positioned in their market and have the relationships and access to off-market opportunities, as well as the platform and team to execute on a value creation strategy. Finding solid investment opportunities, we believe, will require extra due diligence and patience in acquiring the right asset at the right time. Being a regionally focused team with strong regional relationships and a rock-solid reputation will be paramount to uncovering and securing good investment opportunities.

Rising development costs have made it more difficult to achieve an acceptable yield on cost. Particularly in multi-family development, creating value through creative land assemblages, optimizing zoning and entitlements, increasing density, designing a project with cost and constructability in focus and/or ensuring that a development contains the proper unit mix, sizes and amenities for the market are more important now than ever.

## **ABOUT BLUE HERON ASSET MANAGEMENT**

Blue Heron is a private equity real estate firm with a primary focus on multi-family and mixed-use assets in high-growth secondary markets in the Southeast. The firm's strategy is to create value by acquiring opportunistically and growing net operating income through active asset management, operational repositioning, renovations and/or ground-up development.

[blueheronassetmanagement.com](http://blueheronassetmanagement.com)

# OUTLOOK FOR 2019

2018 was a challenging year to be operating a real estate portfolio. Interest rates were on the rise, more participants were active in the market and high valuations made it difficult to find value. In response, many fund managers sought to adapt their offerings, whether by taking on more risk or by expanding their strategy to different markets. While such conditions are likely to prevail in 2019, market dynamics may yet change. Fund managers and investors are largely agreed that property is overpriced and that a market correction is on the horizon; where they are not aligned, however, is the potential timing of this correction.

## GENERATING RETURNS IN 2019

Moving into 2019, Preqin's surveys revealed that a majority of fund managers and investors perceive two key challenges in the private real estate market: rising interest rates and asset valuations (Fig. 19). Rising interest rates are a concern for industry participants as they impact valuations, capitalization rates and the cost of finance. Although fund managers may struggle to generate meaningful returns in such conditions, strong demand for real estate is likely to continue: economic growth is in line with interest rate rises and investors are planning further capital deployment.

The majority (60%) of surveyed private real estate fund managers witnessed a rise in prices over 2018. Asset valuations have become an increasing concern in recent years as competition, demand and the level of capital available to fund managers have inflated property prices. Other respondents believe deal flow (24%) and the exit environment (22%) will be key obstacles for return generation in 2019.

## A POTENTIAL CORRECTION

The majority of fund managers and investors surveyed by Preqin believe property is overpriced (Fig. 20). However, a significant 46% of investors feel property is currently fairly valued or even below its potential, compared with 36% of fund managers. That being said, GPs are undecided as to whether a correction in prices will happen in the first months of 2019, at some point later in the year or in 2020 or

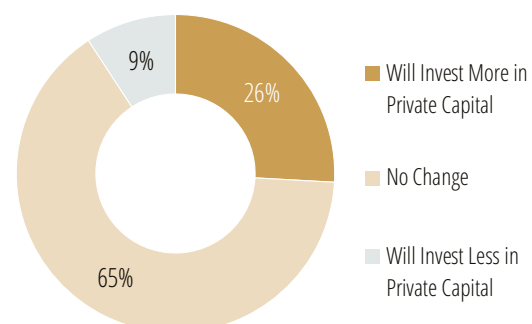
beyond. Among managers that believe the property market is overvalued, 62% anticipate a correction within the next 12 months.

## DEMAND FOR REAL ESTATE IN 2019

Against a backdrop of uncertainty, it is unsurprising that one-third of surveyed investors expect private real estate fund performance to dip in 2019. That being said, over half (53%) are predicting the industry will deliver the same level of performance in 2019 as in 2018.

Positively, the majority (58%) of investors will commit the same amount of capital to real estate in 2019 as they did in 2018, with a further 23% intending to increase their capital investment. While this does leave 19% of investors that are planning to invest less capital in 2019, this short-term view of investor sentiment is likely a reflection of the current market uncertainty, as investors are committed to real estate in the longer term. Just 10% plan to reduce their allocation in the longer term, and 36% aim to increase the proportion of their investment portfolio represented by real estate. In the past, the private fund model has weathered challenging environments to record success, and market participants will look for similar outperformance in the coming year.

**Fig. 18: Real Estate Investors' Plans to Alter Their Level of Private Investment in Response to the Cycle**



Source: Preqin Investor Interviews, November 2018

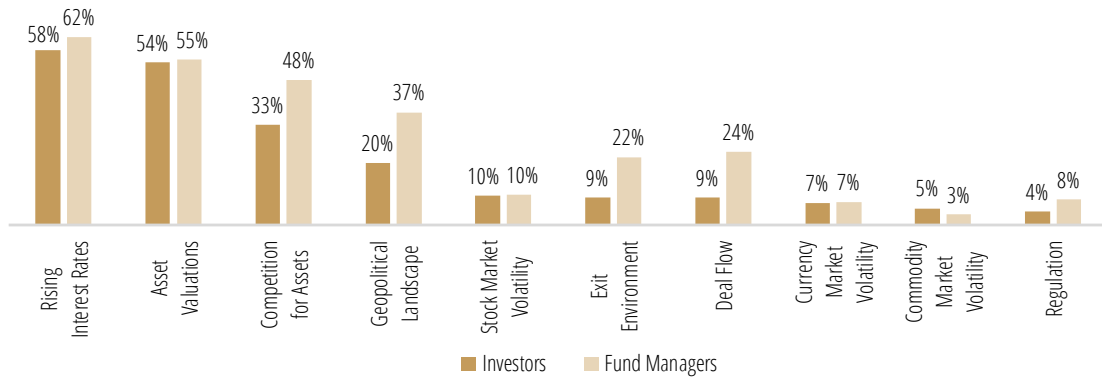


71% of surveyed fund managers and 64% of surveyed investors believe we are at the peak of the market cycle.



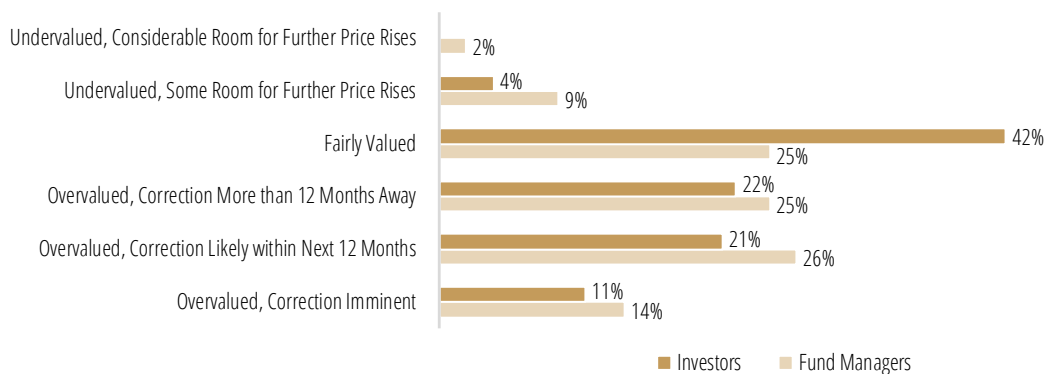
81% of surveyed investors will invest more or the same amount of capital in real estate in 2019 compared to 2018.

**Fig. 19: Views on Key Challenges for Return Generation in 2019: Investors vs. Fund Managers**



Source: Preqin Fund Manager and Investor Surveys, November 2018

**Fig. 20: Views on Real Estate Asset Pricing: Investors vs. Fund Managers**



Source: Preqin Fund Manager and Investor Surveys, November 2018

*The ongoing expansion of e-commerce will continue to disrupt both the retail and industrial sectors. Penn Square will leverage Clarion Partners' industrial platform to take advantage of that shift through off-market industrial investments.*

“

*Rick Schaupp, Managing Director/ Portfolio Manager, Clarion Partners*



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